Daiwa Securities

Daiwa's View

US long-term yield declined to the 3.4% level at one point

- Real yields are approaching the 1% floor set by the Fed on the entire yield curve

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Real yields are approaching the 1% floor set by the Fed on the entire yield curve

◆ Core PCE price index fell to upper 2% range m/m annualized

The US long-term yield temporarily declined to the 3.4% level amid a decline in the core PCE price index to 0.22% m/m with the ISM Manufacturing Index falling below 50. The decline in the core PCE price index to 2.66% m/m annualized in particular has great implications. Fed Governor Christopher Waller stated that a requirement for suspending rate hikes was a decline in the core PCE price index to 2.5-3% m/m annualized. Yesterday's data is within the range required for rate-hike suspension set by Governor Waller. Of course, policymakers do not make judgments based solely on one month's data, but it will be impossible for the market to ignore this favorable core PCE data.

Fed Governor Christopher Waller (14 Jul 2022)
・Until I see a significant moderation in core prices, I support further rate hikes. The core PCE deflator would have to slow to +2.5-3% m/m annualized (as the upper limit for suspending rate hikes).

◆ In light of the real yield curve control by the Fed, leeway for near-term drop is limited

As a result of the substantial drop in yields for two consecutive business days, the 10-year real yield fell from 1.48% to 1.13%. Therefore, the leeway for a near-term drop is limited. If we look at remarks from Fed officials related to real yields, we see that Fed vice Chair Lael Brainard expressed a sense of satisfaction that "we've seen the entire curve from one to 10 years move above 1% in real terms." In his speech at the end of last month, Fed Chair Jerome Powell also mentioned that Fed officials would be looking for significant positive real rates across the yield curve. With the Fed trying to control the entire yield curve at real rates of 1% or higher, leeway for a near-term decline in the 10-year US real yield is around another 10bp.

However, the yield curve control (lower limit of 1%) for real yields is just a constraining measure until the core PCE price index cools down to 2%. Once a consistent decline to 2% in the core PCE price index is confirmed, the Fed is naturally expected to return to its dual mandate objectives, with the federal funds rate returning to the neutral level. Of course, the 1% floor set by the Fed is unlikely to be broken soon, but it is a fact that the 10-year US real yield still has leeway to decline substantially, specifically more than 60bp, compared to the real neutral interest rate in the Summery of Economic Projections set by the FOMC. How things develop will depend on employment and inflation data, but if, for example, the headline for NFPs were to decline to the 100,000 job level tomorrow, it wouldn't be surprising if market participants started to challenge the 1% floor for the 10-year real yield due to stronger speculation about the return to the dual mandate objectives. If so, the Fed would naturally move to push back against that. However, if inflation subsides going forward, market participants who go on the attack will likely come out winners.

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